

**STATE OF ALABAMA  
DEPARTMENT OF INSURANCE  
MONTGOMERY, ALABAMA**

**REPORT OF EXAMINATION OF**

**NATIONAL SECURITY FIRE & CASUALTY  
COMPANY**

**ELBA, ALABAMA**

**AS OF DECEMBER 31, 2004**

**PARTICIPATION:  
SOUTHEASTERN ZONE, NAIC  
ALABAMA**

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**STATE OF ALABAMA  
COUNTY OF COFFEE**

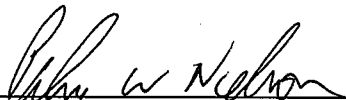
I, Palmer W. Nelson, being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

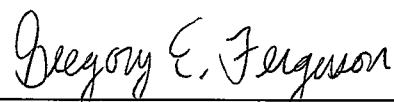
That an examination was made of the affairs and financial condition of National Security Fire & Casualty Company for the period of January 1, 2001, through December 31, 2004;

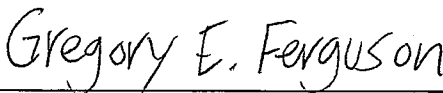
That the following 49 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And that the statements, exhibits and data therein contained are true and correct to the best of his knowledge and belief.

  
\_\_\_\_\_  
Palmer W. Nelson, CFE

Subscribed and sworn to before the undersigned authority this 20th day of April, 2006.

  
\_\_\_\_\_  
(Signature of Notary Public)

  
\_\_\_\_\_, Notary Public  
(Print Name)

in and for the State of Alabama.

My commission expires 2/28/09.

**MY COMMISSION EXPIRES 02-28-09**



**BOB RILEY**  
GOVERNOR

**STATE OF ALABAMA**  
**DEPARTMENT OF INSURANCE**  
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Elba, Alabama  
April 20, 2006

**WALTER A. BELL**  
COMMISSIONER  
ASSISTANT COMMISSIONER  
RAGAN INGRAM  
DEPUTY COMMISSIONERS  
D. DAVID PARSONS  
CHIEF EXAMINER  
RICHARD L. FORD  
STATE FIRE MARSHAL  
ED PAULK  
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RALPH REYN NORMAN  
RECEIVER  
DENISE B. AZAR  
LICENSING MANAGER  
JIMMY W. GUNN

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Chairman, Examination Oversight Committee  
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Honorable Jorge Gomez, Commissioner  
Secretary, Midwestern Zone  
Office of the Commissioner of Insurance  
State of Wisconsin  
Post Office Box 7873  
Madison, Wisconsin 53707-7873

Honorable Walter A. Bell, Commissioner  
Secretary, Southeastern Zone  
Alabama Department of Insurance  
Post Office Box 303351  
Montgomery, Alabama 36130-3351

Dear Director and Commissioners:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and condition of

National Security Fire & Casualty Company  
Elba, Alabama

as of December 31, 2004, at its home office located at 661 East Davis Street, Elba, Alabama 36323. The report of examination appears herewith.

Where the term "Company" appears herein without qualification, it will be understood to indicate National Security Fire & Casualty Company.

## **SCOPE OF EXAMINATION**

The Company was last examined for the five year period ended December 31, 2000, by examiners representing the Alabama Department of Insurance. The current examination covers the intervening period from the date of the last examination through December 31, 2004, and was conducted by Alabama Department of Insurance examiners. When deemed appropriate, transactions subsequent to 2004 were reviewed. The examination was made in accordance with the statutory requirements of the Alabama Insurance Code and the Alabama Insurance Department's regulations and bulletins; in accordance with the applicable guidelines and procedures promulgated by the NAIC; and in accordance with generally accepted examination standards and practices in connection with the verification of assets and determination of liabilities.

The examination included an inspection of corporate records, test checks of recorded income and disbursement items for selected periods and a general review of records and files pertaining to operations, administrative practices and compliance with statutes and regulations. Assets were verified and valued and all known liabilities were established or estimated as of December 31, 2004, as shown in the Financial Statements contained herein. However, the discussion of specific assets and liabilities in this report is confined to those items where a change was made by the examiners, or which indicated violation of the Alabama Insurance Code and the Insurance Department's rules and regulations or other insurance laws or rules, or which are deemed by the examiners to require comments or recommendations.

Company office copies of the filed Annual Statements for the years 2001 through 2004 were compared with or reconciled to account balances with respect to ledger items.

The market conduct review consisted of a review of the Company's plan of operation, territory, policy forms and underwriting practices, advertising and marketing, claims, policyholder complaints, agents' licensing practices and compliance with privacy standards.

The Company's accounts were examined by Barfield, Murphy, Shank & Smith, PC, certified public accountants (CPAs), for each of the four years under examination. The examiners reviewed the CPAs audit reports and certain CPAs work papers. The examiners elected to not use any work performed by the independent auditor. Further discussion of the work performed by the

CPAs is included in this report under the caption "ACCOUNTS AND RECORDS."

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attested to having valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2004.

## **ORGANIZATION AND HISTORY**

The Company was incorporated on January 1, 1959, under the laws of the State of Alabama, as a wholly owned subsidiary of National Security Insurance Company.

Various changes in the amounts and par value of the Company's capital stock occurred between the date of incorporation and 1985. From 1985 through 1991, the authorized capital remained 1,500,000 shares of \$1.00 par value common stock of which 1,000,000 shares were issued and outstanding.

On December 31, 1990, all of the Company's outstanding capital stock was contributed to a newly formed holding company, The National Security Group, Inc. (NSG), a Delaware corporation. Simultaneously, an extraordinary cash dividend for \$10,000,000 was declared by the Company's Board of Directors payable to National Security Group.

On June 30, 1992, the Company paid a stock dividend for 500,000 shares to NSG, thereby increasing the Company's paid up capital to \$1,500,000 consisting of 1,500,000 shares of \$1.00 par value common stock.

The Company's capital structure at December 31, 2004, consisted of 1,500,000 shares of common stock, issued and outstanding, for a total common stock par value of \$1,500,000. The Company also had \$677,190 in gross paid in and contributed surplus and \$21,588,944 of unassigned funds.

## MANAGEMENT AND CONTROL

### Stockholders

The Company is a wholly owned subsidiary of The National Security Insurance Group, Inc., a Delaware corporation.

### Board of Directors

The Company's By-Laws provide that its business and affairs will be managed by a Board of Directors comprised of not less than three nor more than five directors.

The following directors were elected at the March 17, 2004, annual meeting of the Stockholders and were serving at December 31, 2004:

<u>Director/Residence</u>	<u>Principal Occupation</u>
Jack Edward Brunson Elba Alabama	President, National Security Fire and Casualty Company
William Lister Brunson, Jr. Elba, Alabama	President, National Security Insurance Company, CEO, The National Security Group
Mickey Lane Murdock Elba, Alabama	Senior Vice President, National Security Insurance Company Senior Vice President, The National Security Group
Brian Richard McLeod Elba, Alabama	Secretary, National Security Fire and Casualty Company

### Committees

The Company's By-Laws provide that the Board of Directors may designate from among its members one or more committees which shall have and may

exercise all the authority of the Board of Directors except as set forth in the By-Laws. The only committee serving at December 31, 2004, was the Investment Committee, which was comprised of the following members:

Jack Edward Brunson  
William Lister Brunson  
Mickey Lane Murdock  
Brian Richard McLeod

The Investment Committee did not retain minutes of its meetings as required by the ALA. CODE §10-2B-16.01(a)(1975), which states,

A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

### Officers

The By-Laws specify that the Company's officers shall be a President, such Vice Presidents as the Board of Directors may determine, a Secretary, a Treasurer and such other officers as the directors may choose, all of whom shall be elected by and subject to the control of the Board of Directors, and shall serve at the pleasure of the Board of Directors regardless of the term for which they may have been elected. The following officers were elected by the Board of Directors on March 17, 2004, and were serving at December 31, 2004:

<u>Officer</u>	<u>Title</u>
William Lister Brunson, Jr.	Chairman of the Board
Jack Edward Brunson	President
Mickey Lane Murdock	Sr. Vice President & Treasurer
Brian Richard McLeod	Secretary & Assistant Treasurer
Robert Glover	Vice President
Betty Brunson	Assistant Secretary



## Management and Service Agreements

The following agreements between the Company and its affiliates were in effect during the examination period and at December 31, 2004:

### Personnel Agreement

Effective January 1, 1982, National Security Insurance Company (NSIC) accepted all employees of the Company as employees of NSIC. The Company in turn agreed to reimburse NSIC for all expenses involved in the employment of Company personnel. The purpose of this agreement was to bring Company employees under the benefit plans established by NSIC.

### Agreement for Allocation of General and Administrative Expenses

Effective January 1, 1982, this agreement provides for the allocation of salaries, fringe benefits, employment taxes and other common expenses between the Company and National Security Insurance Company (NSIC) on the basis of the ratio of gross written premiums. The agreement also provides that the Company will pay NSIC rent for office space based on a formula tied to NSIC's cost in the building and the number of Company employees.

This agreement was amended June 1, 1994, to include the Company's wholly owned subsidiary, Omega One Insurance Company, which was organized in 1992.

### Agreement for Claims Adjustment Services

Effective July 1, 1981, National Security Insurance Company (NSIC), the Company's life insurer affiliate, agreed to provide and train claims adjustors for the Company, and to adjust claims for the Company and to provide inspection reports for the Company on request. The Company agreed to reimburse NSIC at industry rates on a monthly basis.

The Company failed to comply with the terms of its agreement for claims adjustment services with NSIC. The agreement dated July 1, 1981, provided for NSIC to provide and train claims adjustors for the Company. The agreement stipulated that the Company was to pay NSIC monthly for the services provided. The Company paid the monthly fees for August, September, October and November of 2004 in December 2004.

### Tax Allocation Agreement

The tax allocation agreement in effect at December 31, 2004, has been effective since January 1, 1994. It provides that state and federal income taxes will be allocated among the parties on the basis of the actual tax liability. The parties to the agreement include the following:

The National Security Group, Inc. (NSG, holding company)  
National Security Insurance Company  
National Security Fire and Casualty Company  
Omega One Insurance Company  
NATSCO, Inc.

The tax allocation agreement was amended on January 21, 2002, to clarify the arrangement regarding tax related settlements between the parties. Each affiliate's balance each year will be calculated on an individual company basis. NSG will make all federal income tax deposits. In the event that an individual company has a tax benefit that can be used to offset the taxable income of another affiliated company in the consolidated federal tax return, any tax savings generated by the tax benefit will be remitted by the Company utilizing the tax benefit to the affiliate that generated the tax benefit at the applicable federal tax rate utilized by the entity receiving the benefit.

### Catastrophe Reinsurance Agreement

Effective January 1, 2000, the Company agreed to reinsure catastrophe losses of its subsidiary, Omega One Insurance Company (Omega), in excess of \$250,000 per occurrence. The agreement covers business identified as dwelling fire, allied lines, homeowners and mobile home. In consideration for the premium paid by Omega, the Company agreed to maintain catastrophe reinsurance covering catastrophe losses of the Company and Omega up to \$16 million subject to retentions and reinstatement premiums to be paid by the Company. Omega agreed to pay an annual reinsurance premium to the Company equal to 8.75% of net earned premium in consideration for catastrophe reinsurance coverage provided by the Company. Further discussion of the catastrophe reinsurance agreement is included in this report under the caption "REINSURANCE – Reinsurance Ceded."

### **Conflicts of Interest**

The Company has adopted a policy that requires that any material interest of its directors or officers that conflict, or might conflict, with the interest of the Company be disclosed to its Board of Directors. In order to implement this policy, the Company requires its officers and directors to execute conflict of interest statements annually.

Conflict of interest statements were filed by all directors and officers for all years under examination. No material conflicts were disclosed or noted by the examiners.

### **CORPORATE RECORDS**

The Company's Articles of Incorporation and By-Laws, as amended, were inspected during the course of the examination and appeared to provide for operation of the Company in accordance with usual corporate practices and applicable statutes and regulations.

Minutes of the meetings of the Stockholder and Board of Directors were reviewed for the period under examination. The minutes appeared to be complete and to adequately document the actions of the respective governing bodies.

### **HOLDING COMPANY AND AFFILIATE MATTERS**

#### **Holding Company**

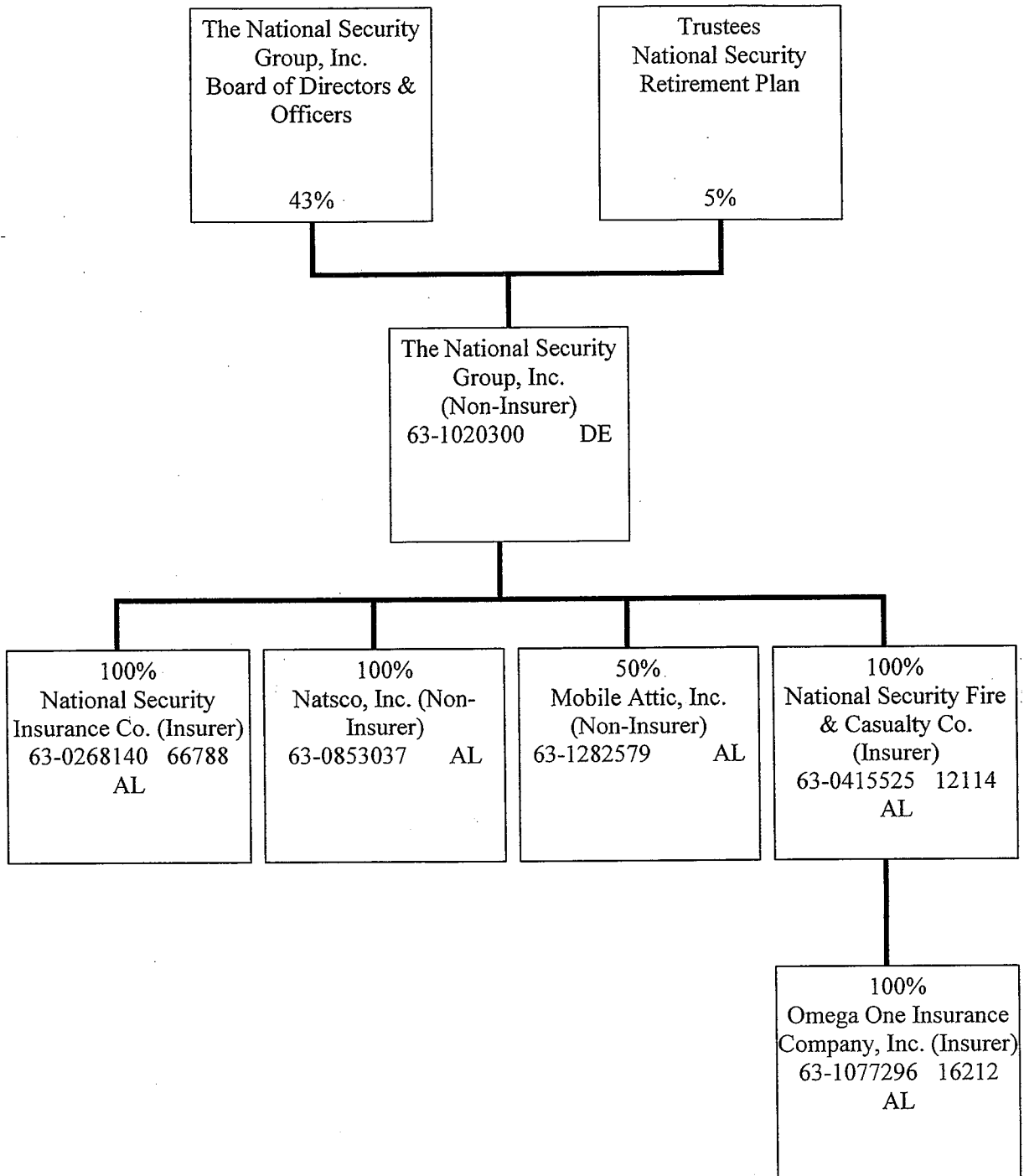
The Company is deemed to be subject to the Alabama Insurance Holding Company Regulatory Act of 1973, as defined in ALA. CODE §27-29-1(1975), as amended. The Company is responsible for holding company registration and periodic informational filings with the Alabama Department of Insurance.

Holding company filings and amendments to registration statements made on behalf of the Company and its affiliates for the years under examination were reviewed. The filings and amendments were found to be complete and to include the required disclosures.

### Organizational Chart

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of December 31, 2004.

## Organizational Chart



### **Dividends to Stockholders**

During the period under examination the following cash dividends were paid to stockholders:

<u>Year</u>	<u>Dividends Paid</u>
2001	\$1,575,000
2002	\$1,700,000
2003	\$1,550,000
2004	\$2,000,000

Dividends paid were in accordance with Alabama statutes and regulations.

### **FIDELITY BOND AND OTHER INSURANCE**

The Company was insured by a Financial Institution Bond issued by Fidelity and Deposit Company of Baltimore, Maryland, at December 31, 2004. The bond provided dishonesty and fraud coverage for salaried officers, employees and persons with employment contracts. The bond did not provide coverage for forgery and alteration of securities. The Company's two insurer affiliates within the holding company system are also covered under the fidelity bond. The limit of coverage is to be applied to losses of all three in the aggregate. The limit of coverage of the fidelity bond did not meet the minimum amount suggested by the NAIC Financial Condition Examiners Handbook. The suggested minimum amount of fidelity bond coverage is from \$700,000 to \$800,000. The limit of coverage for the fidelity bond covering the Company and its two insurer affiliates is \$500,000.

In addition to the fidelity bond coverage, the Company was a named insured under policies providing the following protection at December 31, 2004:

- Commercial Property
- Electronic Data Processing Coverage
- Comprehensive Business Liability
- Comprehensive Automobile Fleet
- Comprehensive Business Umbrella Policy
- Boiler and Machinery
- Workers' Compensation
- Employment Liability
- Fiduciary Liability

Directors and Officers Liability  
Outside Directorship Liability

The coverage and limits of the Company's insurance were reviewed and were deemed to adequately protect the Company's interest.

**EMPLOYEE AND AGENT WELFARE**

The Company did not have any employees at December 31, 2004; therefore, it had no employee benefit plans. All functions of the Company were performed by employees of National Security Insurance Company via administrative service agreements and certain functions performed by agents acting under the authority of agency agreements.

**STATUTORY DEPOSITS**

At December 31, 2004, as required or permitted by law, the Company maintained deposits with the respective statutory authorities as follows.

<u>State</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Alabama (1)	\$1,250,000	\$1,115,604	\$1,143,090
Georgia	\$50,000	\$50,000	\$50,000
Louisiana	125,000	123,424	132,974
South Carolina	500,000	484,409	488,435
Other	27,500	27,611	28,981

(1) Held for the protection of all policyholders.

**FINANCIAL CONDITION/GROWTH OF THE COMPANY**

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004*</u>
Admitted Assets	\$39,891,545	\$40,037,466	\$52,071,167	\$51,353,481
Liabilities	16,319,792	19,836,891	28,966,775	28,325,477
Common Capital Stock	1,500,000	1,500,000	1,500,000	1,500,000
Paid in and Contributed Surplus	677,190	677,190	677,190	677,190
Unassigned Funds	21,394,563	18,023,384	20,927,202	20,850,842
Gross Written Premium	18,110,512	26,773,336	43,754,406	48,438,335

\*Per Examination

## **MARKET CONDUCT ACTIVITIES**

### **Territory**

At December 31, 2004, the Company was licensed to transact business in the following states:

Alabama	Mississippi
Arkansas	Oklahoma
California	South Carolina
Florida	Tennessee
Georgia	

The certificates of authority from the respective jurisdictions were inspected and found to be in order.

### **Plan of Operation**

The Company's business was produced by independent agents and brokers. The agents write business in the nine states in which the Company is licensed. Independent agents also market on a non-admitted basis in the states of Kentucky, Louisiana, Missouri, New York and Texas.

### **Policy Forms and Underwriting**

The examination of the Company's underwriting practices included a review of the Company's underwriting guidelines and a review of the declined applications and the policy cancellations. The information and files were reviewed for indications of unfairly discriminatory practices and to verify that the Company's underwriters and producers have consistently applied the Company's guidelines for all business selected and declined.

A sample of 50 cancellations initiated by the Company was selected from the total of 3,661 cancellations. The examination indicated that 49 of the cancellations complied with the policy provisions. However, one of the policy files had been lost or misplaced and could not be provided to the examiners.



A sample of 50 rejected or declined applications was selected from the total of 3,565 rejections and declinations. The examination indicated that 43 of the files documented the reason for declination and the decision was not unfairly discriminatory. Four files did not include documentation that evidenced the reason that the application was declined. Three of the files had been lost or misplaced and could not be provided to the examiners.

ALA. CODE §27-27-29(a)(1975) states, in part, "Every domestic insurer...shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

The examiners obtained and examined the policy form filings for the policy forms in which business was written in Alabama during the examination period. The Company was unable to provide evidence of the Commissioner's approval of one of its policy forms in which the Company wrote business on during the examination period.

ALA. CODE §27-14-8(a)(1975) states,

No basic insurance policy or annuity contract form or application form where written application is required and is to be made a part of the policy, or contract, or printed rider, or endorsement form or form of renewal certificate shall be delivered or issued for delivery in this state unless the form has been filed with, and approved by, the commissioner...

### **Advertising and Marketing**

The National Security Group, Inc. (NSG), the holding company, did general corporate advertising without identifying specific products. The Company filed certificates of compliance for all years under examination stating that the advertisements, which were disseminated by or on behalf of the Company, complied, or were made to comply, with the provisions of the statutes of the State of Alabama.

The Company maintains a general purpose web site (hosted by NSG). The web site is designed to provide information about products, employment opportunities, claim reporting, contact options and agency listings. Agents are not authorized to maintain separate individual web sites. It was determined

that the Company's internet advertising was not misleading and contained appropriate language to identify the policy form(s) that was being advertised in accordance with applicable statutes, rules and regulations.

The Company published an internal quarterly newsletter entitled *The National Security Advisor*. The newsletter was circulated in regions where the Company wished to promote its programs and/or to highlight individual or agency accomplishments.

The Company's producers are only permitted to use materials for advertising which have been pre-approved by the marketing division. The Company does not authorize agents to advertise for National Security Fire & Casualty Company.

### **Claims Review**

The review of the closed claim files indicated that claims were paid in accordance with policy provisions and that settlements were made promptly upon the receipt of evidence of the Company's liability. The Company resisted payments only in cases where there appeared to be justifiable cause for further investigation or denial. However, noteworthy exceptions were found. The exceptions are detailed below.

A sample of 50 closed and denied claims was selected from the 1,680 claims that were closed and denied during the examination period. The examination of the sample indicated that the Company did not properly acknowledge three of the claims within 15 days. ALA. ADMIN. CODE 482-1-125-.06(1) states the following:

- (1) Every insurer, upon receiving notification of a first party claim from a first party claimant shall, within fifteen (15) days, acknowledge the receipt of such notice unless payment is made within that period of time. If an acknowledgement is made by means other than writing, an appropriate notation of the acknowledgement shall be made in the claim file of the insurer and dated. Notification given to a producer of an insurer shall be notification to the insurer. Acknowledgement by a producer of an insurer as required above shall satisfy the requirements of this paragraph.

In addition, the review of the sample of 50 closed and denied claims indicated that two of the closed claims should have been reopened when the information requested from the claimant was received, but were not.

A sample of 100 paid claims was selected from the 54,920 claims that were paid during the examination period. The Company could not provide the complete claim files for six of the sample selections. The six incomplete claim files did not include information to provide evidence that the Company had acted in accordance with policy provisions when settling the claims.

ALA. ADMIN. CODE 482-1-125.04 states:

File and record documentation

Each insurer's claim files for policies are subject to examination by the Commissioner of Insurance or by the Commissioner's duly appointed designees. To aid in such examination:

(a) The insurer shall maintain claim files that are accessible and retrievable for examination. An insurer shall be able to provide the claim number, line of coverage, date of loss, and date and amount of payment. They shall also be able to provide the same information (except date and amount of payment) for all claims closed without payment. This data must be available for all open and closed files for the current year and the five (5) preceding years, in order to permit reconstruction of the insurer's activities relative to each claim.

(b) Each relevant document within the claim file shall reflect as to date received, date processed or date mailed.

The examination noted that the Company has not maintained its file and record documentation as required by the aforesaid Code Section.

**Policyholder Complaints**

During the examination period the Alabama Department of Insurance recorded 120 complaints that were filed against the Company. The Company recorded 112 complaints in its complaint register during the examination period. The Company is not notified of all complaints reported to the Alabama Department of Insurance

The review of the complaint files that were maintained by the Company indicated that the claimants' issues were properly addressed and resolved. However, it was noted that the review indicated that one of the complaints reported to the Alabama Department of Insurance was not responded to by the Company within ten business days of being notified of the complaint.

Alabama Insurance Department Regulation No. 118 §(6)(s) states, "The insurer shall provide, within ten (10) working days, any record or response requested in writing by any duly appointed deputy, assistant, employee or examiner of the commissioner..."

### **Compliance with Agents' Licensing Requirements**

The Company had 2,932 licensed agents at December 31, 2004. There were 908 agents appointed in Alabama.

The examiners compared the Company's list of licensed and appointed agents with the list provided by the Alabama Department of Insurance. Additionally, the examiners selected a sample of 100 new policies issued from 11,853 new policies issued during 2004 to determine whether all producers were properly licensed and appointed. The review of the sample identified nine agents who were not appointed in accordance with ALA. CODE §27-7-30(a)(1975). However, upon further examination, it was determined that each of the nine agents wrote occasional business and submitted it through an appointed agent, in accordance with ALA. CODE §27-7-34(a), which states, "On an occasional basis, a producer may place with an insurer for which he or she is not appointed only a kind of insurance or classification thereof for which the producer is licensed by placing the insurance through a duly appointed producer of the insurer." Regulation No. 58 §III defines occasional business as follows: "Any agent submitting to another agent under the authority of 27-7-34 shall not submit to the accepting agent on a 'cash with application basis' more than 10 policies in any one calendar month..."

### **Privacy Standards**

The Company does not share customers' private information with any nonaffiliated third parties except those permitted under Sections 14, 15 and 16 of ALA. ADMIN. CODE 482-1-122. The Company had adequate controls in

place for employees that handled private information. As for the private information shared among the affiliated entities, the Company provided notices to its customers that indicated the types of information collected, the way it was used and the manner in which it was collected.

## **REINSURANCE**

### **Reinsurance Assumed**

The Company had a catastrophe reinsurance agreement with its affiliate, Omega One Insurance Company (Omega) effective January 1, 2000, without expiration. This is the only reinsurance assumed by the Company during the examination period.

The Company revised its catastrophe reinsurance agreement with Omega effective January 1, 2002. The revised catastrophe reinsurance agreement does not contain a provision for premiums and losses and payment of losses reporting as specified by SSAP No. 62, paragraph 8(d). Also, the revised agreement does not contain an errors and omissions clause.

**Business Covered** - Dwelling and commercial fire, allied lines, homeowners and mobile homes.

**Term** - Effective for the year beginning January 1, 2000, without expiration.

**Retention and Limits** – The Company agrees to reinsure catastrophe losses of Omega in excess of \$250,000 per occurrence. The Company will maintain catastrophe reinsurance covering losses of the Company and Omega up to \$16 million subject to co-reinsurance premiums to be paid by Omega. However, during 2004, the Company and Omega were reinsured up to \$35 million.

The Company ignored its obligations under the catastrophe reinsurance agreement with its wholly owned subsidiary, Omega One Insurance Company. Under the terms of the catastrophe reinsurance agreement, the Company agreed to reimburse its subsidiary for catastrophe losses exceeding \$250,000 for any one occurrence. For CAT Occurrence 74, which occurred in October 2002, the subsidiary incurred catastrophe losses in excess of \$605,000 including losses and loss adjustment expenses. The Company ignored its obligation of \$355,709 to reimburse Omega One Insurance Company for valid losses and

related expenses. Further discussion of the obligation is included in this report under the caption "NOTES TO FINANCIAL STATEMENTS."

### Reinsurance Ceded

#### Catastrophe Excess Reinsurance Contract (four layers)

The Company's subsidiary, Omega One Insurance Company (Omega), was also covered under the contract. The limits of the reinsurance were applicable to combined losses of the Company and Omega. The pertinent terms of the reinsurance contract are described as follows:

Business Covered - Dwelling and commercial fire, allied lines, homeowners, mobile homes, inland marine and special multi-peril.

Term - Effective January 1, 2004, to January 1, 2005, with respect to all losses occurring (or beginning) during the term of the contract.

#### Retention and Limits:

First Layer - 95% of \$3,000,000 or \$2,850,000 each occurrence, in excess of \$2,000,000, not to exceed 95% of \$6,000,000 or \$5,700,000, in respect to all loss occurrences during the term of the agreement.

Second Layer - 95% of \$5,000,000 or \$4,750,000 each occurrence, in excess of \$5,000,000, not to exceed 95% of \$10,000,000 or \$9,500,000, in respect to all loss occurrences during the term of the agreement.

Third Layer - 95% of \$7,500,000 or \$7,125,000 each occurrence, in excess of \$10,000,000, not to exceed 95% of 15,000,000 or \$14,250,000, with respect to all loss occurrences during the term of the agreement.

Fourth Layer - 100% of \$17,500,000 each occurrence, in excess of \$17,500,000, not to exceed 100% of \$35,000,000 with respect to all loss occurrences during the term of the agreement.

Reinsurers and percentage of participation:

	<u>1st Layer</u>	<u>2nd Layer</u>	<u>3rd Layer</u>	<u>4th Layer</u>
Ace Tempest Reinsurance Limited	7.00%	7.00%	NIL	2.00%
IPCRé Underwriting Services Limited on behalf of Allied World Assurance Company Limited	25.00%	15.00%	17.50%	17.50%
American Agricultural Insurance Company	3.00%	3.00%	2.00%	3.00%
AXA Re	2.00%	2.00%	5.00%	5.00%
Dorinco Reinsurance	6.00%	6.00%	NIL	NIL
Hannover Re (Bermuda) Limited	NIL	3.00%	10.00%	10.00%
IPCRé Limited	25.00%	15.00%	17.50%	17.50%
Montpelier Reinsurance Ltd	6.00%	10.00%	NIL	NIL
MS Frontier Reinsurance Limited	NIL	NIL	NIL	10.00%
Regional Treaty Services Facility 2003/2004	3.00%	2.00%	7.00%	2.00%
Reinsurance Reinsurance Ltd.	NIL	2.00%	NIL	2.00%
Shelter Mutual Insurance Company	1.50%	1.50%	2.00%	2.00%
Transatlantic Reinsurance Company	NIL	14.00%	NIL	NIL
Across the Board Facility (2004)	1.50%	1.00%	8.00%	3.00%
Lloyd's Underwriter Syndicates	20.0%	18.50%	31.00%	26.00%
	100.00%	100.00%	100.00%	100.00%

All reinsurers were rated A- or higher by Best's Insurance Reports or were rated B or higher by Moody's.

### Marine Quota Share Reinsurance Agreement

Business Covered - Company marine insurance is produced by Pro-Mar Insurance Underwriters, Inc., and underwritten by George W. Zanthos, Birmingham, Alabama.

Term - July 1, 2004, to June 30, 2005, with respect to all policies written on or after that date and all risks attaching.

Territory - The inland and coastal waters of the 48 contiguous United States; however, subject business shall emanate from Florida, Georgia, Alabama, Mississippi, Louisiana and Texas only.

Retention and Limits - 60% quota share ceded; maximum line any one Hull shall not exceed \$750,000 for 100% and maximum line for P&I shall not exceed \$500,000 for 100%. The Company is permitted to maintain excess of loss reinsurance in respect of its net retained liability.

Reinsurers and percentage of participation - Lloyd's Underwriters is the only subscribing reinsurer. The percentage of participation is 100%.

### Marine Multiple Layer Excess of Loss Reinsurance Agreement

Business Covered - Company marine insurance produced by Pro-Mar Insurance Underwriters, Inc., and underwritten by George W. Zanthos, Birmingham, Alabama.

Term - Effective July 1, 2004, to July 1, 2005, with respect to all losses on or after that date and all risks attaching.

Territory - The inland and coastal waters of the 48 contiguous United States; however, subject business shall emanate from Florida, Georgia, Alabama, Mississippi, Louisiana and Texas only.

Retention and Limits - 40% of \$1,500,000 Ultimate Net Loss each and every loss or series of losses arising out of one event or occurrence in excess of \$562,500 Ultimate Net Loss each and every loss or series of losses arising out of one event or occurrence.



Reinsurers and percentage of participation – Lloyd's Underwriters and Wurttembergische Versicherung are the only subscribing reinsurers. The percentage of participation is 50% each.

The Company failed to ensure that two ceded reinsurance contracts were signed within the time limit specified by SSAP No. 62, paragraph 23, which states, "If an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commence of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement."

### Reinsurance Intermediary

The property catastrophe reinsurance is administered by reinsurance intermediary Guy Carpenter, Roswell, Georgia. Interest and liabilities contracts with the subscribing reinsurers are provided as follows.

1. Guy Carpenter is recognized as the intermediary negotiating the agreement.
2. All communications between the parties shall be transmitted through the intermediary.
3. Payments by the Company to the intermediary shall be deemed to constitute payment to the reinsurers. Payments by the reinsurers to the intermediary shall be deemed to constitute payment to the Company, only to the extent that such payments are actually received by the Company.

### Insolvency Clause

All of the Company's ceded reinsurance agreements contained the usual insolvency clause, which provides for reinsurance payments to a liquidator, receiver or statutory successor without diminution because of the insolvency of the ceding insurer.

## ACCOUNTS AND RECORDS

The Company's principal accounting records are maintained by computer with certain subsidiary records maintained manually. Generally, the Company's records were adequate to reflect the Company's transactions during the examination period and its financial condition at December 31, 2004. However, the examiners encountered the following instances that warrant comments in this report.

### Independent Auditor

The Company was audited for the years under examination by the certified public accounting firm of Barfield, Murphy, Shank & Smith, P.C., Birmingham, Alabama. It was noted that Jack Knight, CPA, was the person responsible for the 2004 independent auditor's report and that he had served in that capacity each year since 1992. Alabama Department of Insurance Regulation 482-1-100-.07(4)(a) states, "No partner or other person responsible for rendering a report may act in that capacity for more than seven (7) consecutive years..." The Company did not comply with the aforesaid regulation.

The audit reports and work papers of the independent auditor were reviewed by the examiners. The examiners did not utilize the work performed by the independent auditor.

The independent auditor did not include a review by a qualified actuary of the loss and loss adjustment expense reserves developed by the Company's consulting and opining actuary. The Company's consulting and opining actuary's work was relied upon. The examiners noted that the Company's consulting and opining actuary has been preparing an original work product that has not been subjected to review and/or testing by any independent, qualified third party with the exception of the periodic Alabama Department of Insurance statutory examinations.

As for utilizing a specialist that has a relationship with the client, the AICPA Professional Standards stipulates in Sections 336.10 and 336.11,

The auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has the ability---through employment, ownership, contractual right, family

relationship, or otherwise---to directly or indirectly control or significantly influence the specialist. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. However, the work of a specialist who has a relationship with the client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

The examiners determined that the Company's consulting actuary does have a relationship with the client through employment that may impair the actuary's objectivity. The CPA did not document the assessment of the risk of impaired objectivity or determine the necessity of performing additional procedures with respect to the actuary's assumptions, methods or findings.

#### The Company Made Payment for Obligations of an Affiliate

The examination noted that the Company made a payment of \$49,043 for the second quarter 2004 premium taxes of its wholly owned subsidiary, Omega One Insurance Company. The error was discovered by Company personnel who corrected the error when it was discovered.

#### Loan from Subsidiary

The examination noted that the Company borrowed from its wholly-owned subsidiary, Omega One Insurance Company. It was a violation of a statute for Omega One Insurance Company to make a loan to its parent, the Company. ALA. CODE §27-41-36(a)(1975) states,

After January 1, 1978, an insurer shall not invest in nor lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer, except as to policy loans authorized under Section 27-41-25 and except as provided in Sections 27-1-2, 27-27-26 and 27-32-2 of the Alabama Insurance Code.

It was noted that the most recent examination performed by the Alabama Department of Insurance resulted in a recommendation for the Company to cease the practice of borrowing funds from its subsidiary. Further discussion of the loan from the Company's subsidiary is included in this report under the caption "COMPLIANCE WITH PREVIOUS RECOMMENDATIONS."

#### Incomplete Records

The examiners verified the accuracy of records for a sample of policies included in the Company's premium database by reconciling the data to the original policy applications. The examination noted that the Company could not provide the original policy application for one policy in the sample. ALA. CODE §27-27-29(a)(1975) states, in part, "Every domestic insurer...shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

#### Improper Accounting Recognition of a Prepaid Expense

The Company reported a prepayment of premium taxes as a negative liability reported in the line item "Taxes, licenses and fees" in its 2002 Annual Statement. Pre-paid expenses are to be reported as a non-admitted asset in accordance with SSAP No. 29, paragraph 2, which states, in part, "Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus)."

#### Outstanding Checks Were Not Included in Unclaimed Property Reports

It was determined that the Company did not include in its unclaimed property filings outstanding checks that have remained outstanding in excess of five years. Company management's position was that checks that the Company has issued for the payment of claims that have been outstanding more than five years are not unclaimed property. The examiners did not agree with the position.

ALA. CODE §35-12-23(b) identifies unclaimed property as follows.

" 'Unclaimed funds', as used in this section, means all moneys held and owing by any insurance corporation unclaimed and unpaid for more than five years after the moneys became due and payable as established from the records of the corporation." As for identifying the unclaimed property that is escheatable to the State of Alabama, ALA. CODE §35-12-23(a) states, "Unclaimed funds,

as defined in this section, held and owing by an insurance corporation shall be presumed abandoned if the last known address, according to the records of the corporation, of the person entitled to the funds is within this state."

It was noted that the stale dated outstanding checks were misclassified and reported in the line item "Drafts outstanding." It was noted that the Company did not provide the detail of some of the misclassified balances to evidence the amount, payee and age of the outstanding checks when the examiners requested the information. Further discussion of the outstanding checks is included in this report under the captions "NOTES TO FINANCIAL STATEMENTS - Note 2."

## FINANCIAL STATEMENTS

The financial statements included in this report were prepared on the basis of the Company's records, and the valuations and determinations were made during the examination for the year 2004. Amounts shown in the comparative statements for the years 2001, 2002 and 2003 were compiled from the Company's copies of filed Annual Statements. The statements are presented in the following order:

Statement of Assets, Liabilities, Surplus and Other Funds	Pages 28 and 29
Summary of Operations	Page 30
Capital and Surplus Account	Page 31

**National Security Fire & Casualty Company**  
**Statement of Assets, Liabilities, Surplus and Other Funds**  
**For the Year Ended December 31, 2004**

**Assets**

	<b>Assets</b>	<b>Non- Admitted Assets</b>	<b>Admitted Assets</b>
Bonds <u>(Note 1)</u>	\$31,546,138	\$	\$ 31,546,138
Preferred stock	736,900		736,900
Common stock <u>(Note 6)</u>	16,260,478		16,260,478
Real Estate: Properties held for the production of income	1,455,321		1,455,321
Cash and short term investments <u>(Note 2)</u>	(3,510,128)		(3,510,128)
Other invested assets <u>(Note 3)</u>	2,891,470	352,453	2,539,017
Investment income due and accrued	340,798		340,798
Premiums and considerations: Uncollected premiums and agents' balances in course of collection <u>(Note 4)</u>	1,099,429	324,266	775,163
Deferred premiums, agents' balances and installments booked but deferred and not yet due <u>(Note 5)</u>	475,692		475,692
Amounts recoverable from reinsurers	494,930	164,140	330,790
Other amounts receivable under reinsurance contracts	261,660		261,660
Electronic data processing equipment and software	143,221	143,221	
Furniture and equipment, including health care delivery Assets	68,325	68,325	
Receivable from parent, subsidiaries and affiliates <u>(Note 4)</u>	141,653		141,653
Aggregate write-ins for other than invested assets	<u>30,040</u>	<u>30,040</u>	
<b>Total Assets</b>	<u>\$ 52,435,927</u>	<u>\$1,082,446</u>	<u>\$ 51,353,481</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

# National Security Fire & Casualty Company

## Statement of Assets, Liabilities, Surplus and Other Funds

### Liabilities, Surplus and Other Funds

Losses	\$ 7,706,001
Reinsurance payable on paid loss and loss adjustment expenses <u>(Note 6)</u>	355,709
Loss adjustment expenses	718,190
Commissions payable, contingent commissions and other similar charges	827,717
Other expenses (excluding taxes, licenses and fees)	980,372
Taxes, licenses and fees (excluding federal and foreign income taxes)	285,903
Current federal and foreign income taxes	424,116
Net deferred tax liability	2,242,904
Unearned premiums <u>(Note 7)</u>	13,055,606
Ceded reinsurance premiums payable	183,986
Funds held by company under reinsurance treaties <u>(Note 8)</u>	102,320
Amounts withheld or retained by company for account of others <u>(Note 8)</u>	752,116
Provision for reinsurance <u>(Note 9)</u>	341,000
Drafts outstanding <u>(Note 2)</u>	0
Payable to parent, subsidiaries and affiliates	349,505
<b>Total Liabilities</b>	<b>\$28,325,447</b>
Capital and Surplus:	
Common capital stock	\$ 1,500,000
Gross paid in and contributed surplus	677,190
Unassigned funds <u>(Note 10)</u>	20,850,842
<b>Total Capital and Surplus</b>	<b>\$ 23,028,032</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 51,353,479</b>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.



**NATIONAL SECURITY FIRE & CASUALTY COMPANY**  
**SUMMARY OF OPERATIONS**  
For the Years Ended December 31, 2001, 2002, 2003, 2004

	2001	2002	2003	2004
<b>Underwriting Income</b>				
Premiums earned	\$ 15,953,267	\$ 21,981,235	\$36,975,994	\$ 42,315,704
<b>DEDUCTIONS</b>				
Losses incurred	7,499,659	15,303,780	19,298,049	25,563,257
Loss expenses incurred	1,538,548	1,841,475	2,750,687	3,301,286
Other underwriting expenses incurred	6,567,621	8,745,881	13,576,126	15,023,333
Aggregate write-ins for underwriting Deductions	(28,875)			
Total underwriting deductions	<u>\$15,576,953</u>	<u>\$25,891,136</u>	<u>\$35,624,862</u>	<u>\$43,887,876</u>
Net underwriting gain/loss	376,314	(3,909,901)	1,351,132	(1,572,171)
<b>Investment Income</b>				
Net investment income earned	\$ 1,623,199	\$ 1,712,271	\$ 1,727,907	\$ 1,926,914
Net realized capital gains/losses	875,067	621,588	203,326	1,846,602
Net investment gain/loss	<u>\$ 2,498,266</u>	<u>\$ 2,333,859</u>	<u>\$ 1,931,233</u>	<u>\$ 3,773,516</u>
<b>Other Income</b>				
Net gain/loss from agents' or premium balances charged off	\$ (15,209)	\$ 3,598	\$ (93,265)	\$ (35,269)
Finance and service charges not included in premiums	399,325	617,790	884,500	869,540
Aggregate write-ins for miscellaneous Income	586,208	12,105	89,119	88,712
Total other income	<u>\$ 970,324</u>	<u>\$ 633,493</u>	<u>\$ 880,354</u>	<u>\$ 922,983</u>
Net income before federal and foreign Taxes	\$ 3,844,904	\$ (942,549)	\$ 4,162,719	\$ 3,124,328
Federal and foreign income taxes incurred	1,125,366	(153,993)	1,637,188	960,820
Net income	<u>\$ 2,719,538</u>	<u>\$ (788,556)</u>	<u>\$ 2,525,531</u>	<u>\$ 2,163,508</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

**NATIONAL SECURITY FIRE & CASUALTY COMPANY**  
**CAPITAL AND SURPLUS**  
For the Years Ended December 31, 2001, 2002, 2003, 2004

	2001	2002	2003	2004
Capital and surplus, December 31, prior year	\$ 24,170,498	\$ 23,571,753	\$ 20,200,574	\$ 23,104,385
Net income	2,719,538	(788,556)	2,525,531	2,163,508
Change in net unrealized capital gains/losses	(187,933)	(1,630,430)	2,996,529	974,898
Change in net deferred income tax	423,717	390,458	(758,811)	(256,178)
Change in nonadmitted assets	(296,978)	357,349	(309,438)	(546,447)
Cumulative effect of changes in accounting Principles	(1,682,090)			
Change in provision for reinsurance				(341,000)
Dividends to stockholders	(1,575,000)	(1,700,000)	(1,550,000)	(2,000,000)
Aggregate write-ins for gains and losses in surplus				(71,142)
Net change in capital and surplus for the year	(598,745)	(3,371,179)	2,903,811	(76,360)
Capital and surplus, December 31, current year	<u>\$ 23,571,753</u>	<u>\$ 20,200,574</u>	<u>\$ 23,104,385</u>	<u>\$ 23,028,025</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

## **NOTES TO FINANCIAL STATEMENTS**

### **Note 1 – Bonds**

**\$31,546,138**

The above captioned amount is the same as reported in the 2004 Annual Statement.

The Company reported a bond with a par value of \$27,500, of which \$25,000 is pledged to secure a letter of credit for reinsurance, as an admitted asset. The examination of the bond indicated that the bond should have been not admitted. This is consistent with ALA. CODE §27-37-4(b)(1975), which states, "The commissioner shall disallow as an asset any deposit, funds or other assets of the insurer found by him after a hearing thereon...(2) Not freely subject to withdrawal or liquidation by the insurer at any time for the payment or discharge of claims or other obligations arising under its policies..." Due to the adjustment not being material, no change is reflected in the financial statements contained in this report.

Six securities were assigned the NAIC designation "1," while they should have been assigned the designation "1FE." The Company assigned a designation of "1" if a security was rated by only one rating agency; the Company assigned a designation of "1FE" if the security was rated by two or more rating agencies; and the Company assigned a designation of "1" if the security was a governmental agency bond. This does not coincide with the instructions of Part Four, Section 2(c)(i)(A) of the Purposes and Procedures Manual of the NAIC SVO, which states in relation to Company assigned FE ratings, "Bonds, that are: Rated and monitored by one NRSRO, will be assigned the equivalent NAIC Designation. If rated and monitored by more than one NRSRO, then the second highest rating will be assigned." Assigned ratings are identified by the inclusion of "FE."

### **Note 2 – Cash and short-term investments**

**\$(3,510,128)**

#### **Drafts Outstanding**

**\$ 0**

The above captioned amount for "Cash and short-term investments" is \$766,979 less than the amount reported by the Company in its 2004 Annual Statement. The above captioned amount for "Drafts outstanding" is \$766,979 less than the amount reported by the Company in the 2004 Annual Statement.

The examination of the reported drafts outstanding detail indicated that the account was comprised of outstanding checks rather than outstanding drafts.

Accounting personnel indicated that the outstanding checks were reclassified as drafts outstanding when the checks became stale dated. SSAP No. 2, paragraph 7 stipulates, "Outstanding checks are accounted for as a reduction of cash." The balances improperly classified as "Drafts outstanding" were properly classified as "Cash and short-term investments" in the financial statements included in this report.

The examiners requested the detail of the year-end 2004 balance reported as drafts outstanding. The Company could not provide a complete listing of the outstanding obligations recorded in its general ledger. It was explained that a segment of the detail had been lost and could not be provided. The Company's general ledger included liabilities amounting to \$135,654 for obligations of the Company that the Company could not provide any records of. For the liabilities in which the detail was lost, the Company could not provide the examiners a record indicating the amounts of specific balances payable to specific persons, or an indication of the period of time that the outstanding items had remained outstanding. The examination of the balances reported as drafts outstanding indicated that some of the outstanding items were unclaimed property that should have been escheated to the State of Alabama, but was not. Further discussion of the unclaimed property included in the reported balance is included in this report under the caption "ACCOUNTS AND RECORDS - Outstanding Checks Were Not Included in Unclaimed Property Reports."

ALA. CODE §27-27-29(a)(1975) states, in part, "Every domestic insurer...shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted." No adjustment to the financial statements included in this report was determined to be appropriate for this examination finding.

A review of the cash account indicated that twelve outstanding checks totaling \$10,938 were not included in the reported balance. The examination found that this was due to the twelve outstanding checks being checks written by the Company's claims adjustors in the field. The Company's checks are written in the field and a copy of them is sent to the home office. The checks are posted as of the day the Company receives the copies of them. The twelve outstanding checks were written in the field prior to year end 2004, but not recorded in the Company's general ledger until January 2005. Due to the adjustment being immaterial, no change is reflected in the financial statements contained in this report.

A review of the cash account indicated that return items in the amount of \$12,660 from the December 2004 bank statements were not recorded in the Company's general ledger until January 2005. The return items are the result of checks that the Company received from the insured that bounced when deposited or returns from ACH transactions in which an insured's account had insufficient funds when the Company drafted funds from an insured's account. The return items were transactions processed prior to year end 2004, but not recorded in the Company's general ledger until January 2005. Due to the adjustment being immaterial, no change is reflected in the financial statements contained in this report.

The Company reported an incorrect description for the special deposit for Georgia in Schedule E - Part 3 - Special Deposits of the 2004 Annual Statement. Also, there was a minor difference in the par value for the security listed in Schedule E and the par value from the bank confirmation received by the examiners.

The Company reported the incorrect bank for the special deposit for South Carolina in Schedule E - Part 3 - Special Deposits of the 2004 Annual Statement. The security is deposited with Bank of America, N.A. Schedule E - Part 3 of the Annual Statement lists this security as being deposited at SouthTrust Bank of Birmingham.

**Note 3 – Other invested assets**

**\$2,539,017**

The above captioned amount is \$352,453 less than the \$2,891,470 reported in the 2004 Annual Statement.

The change in the reported balance resulted from the examination of an investment reported in Schedule BA. The investment was identified in the schedule as "Georgia Tax Credit." Company officials explained that the investment provided premium tax credits in the State of Georgia as provided for by a Georgia statute. The underlying investments were low income housing. The investment was not submitted to the NAIC Securities Valuation Office for valuation. Alabama Insurance Department Regulation No. 98 Section 2 states,

- A. All securities owned by an insurer shall be valued in accordance with those standards promulgated by the NAIC Securities Valuation Office (SVO). Any security owned by an

insurer that has not been valued by the SVO shall be submitted to the SVO for valuation in accordance with the procedures of the SVO

- B. Other invested assets, not otherwise valued by statute, shall be valued in accordance with the procedures promulgated by the NAIC's Financial Condition (EX4) Subcommittee.
- C. Any security not valued in accordance with this section shall be carried as a non-admitted asset on all financial statements of the insurer until such time as the insurer has complied with subsection A or B or this section.

The investment was not submitted to the NAIC Securities Valuation Office for valuation and was therefore not admitted.

<u>Note 4 – Premiums and considerations: Uncollected</u>	<u>\$775,163</u>
<u>premiums and agents' balances in course of</u>	
<u>collection</u>	
<u>Receivables from parent, subsidiaries and</u>	<u>\$141,653</u>
<u>affiliates</u>	

The above captioned amount for "Premiums and considerations: Uncollected premiums and agents' balances in course of collection" is \$314,507 less than the \$1,089,670 reported by the Company in its 2004 Annual Statement. The above captioned amount for "Receivables from parent, subsidiaries and affiliates" is the same as reported by the Company in its 2004 Annual Statement. Two issues involving the accounts are discussed below. The first, identified below as "Issue 1," involves the "Premiums and considerations: Uncollected premiums and agents' balances in course of collection." The second, identified below as "Issue 2," involves both of the captioned accounts.

#### Issue 1

The Company did not non-admit its agents' receivables on a policy by policy basis which were over 90 days past due in accordance with SSAP No. 6, paragraph 9(c), which states, in part, "The uncollected agent's receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium." The Company's records involve maintaining the balances that are due the Company from each agent. The Company did not provide the examiners with the outstanding detail on a policy by policy basis, even though a detail was requested. The Company's work papers indicated that the amount that the Company had not admitted in its

2004 Annual Statement was balances that were over 90 days past due from the agent.

Company personnel recalculated the nonadmitted balances, nonadmitting the balances in accordance with SSAP No. 6. The Company's calculation identified additional nonadmitted balances that were \$314,507 more than the \$9,759 nonadmitted balances reported by the Company in its 2004 Annual Statement. The calculation performed by Company personnel was determined by the examiners to be reasonable to estimate the overstatement of the asset.

## Issue 2

The Company included an assumed reinsurance premiums balance of \$91,919 in the line item "Receivables from parent, subsidiaries and affiliates" in its 2004 Annual Statement. The balance should be reported in the line item "Premiums and considerations: Uncollected premiums and agents' balances in course of collection" in accordance with SSAP No. 62, paragraph 35, which states, "Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents' balances or uncollected premiums."

The misclassification has no effect upon the Company's surplus. Due to no effect upon surplus, no changes were made to the financial statements included in this report.

<b><u>Note 5 – Premiums and considerations: Deferred</u></b>	<b><u>\$475,692</u></b>
<b><u>premiums, agents' balances and</u></b>	
<b><u>installments booked but deferred and</u></b>	
<b><u>not yet due</u></b>	

The above captioned amount is the same as reported by the Company in its 2004 Annual Statement.

The examination determined that the Company utilized a December 29, 2004, cut-off date for a segment of the Company's business produced by Gulf Administrators of Mobile, Alabama, for reporting deferred premiums, agents' balances and installments booked but deferred and not yet due instead of December 31, 2004.

ALA. CODE §27-3-26(a)(1975) requires that the Company "...file with the commissioner a full and true statement of its financial condition, transactions and affairs as of the December 31, preceding."

The examination indicated that no material adjustment would result from reporting the accounts on the calendar year basis. Therefore, no changes were made to the financial statement contained in this report.

<b><u>Note 6 – Reinsurance payable on paid loss and</u></b>	<b><u>\$ 355,709</u></b>
<b><u>loss adjustment expenses</u></b>	
<b><u>Stocks: Common stocks</u></b>	<b><u>\$16,260,478</u></b>

The above captioned amount for "Reinsurance payable on paid loss and loss adjustment expenses" is \$355,709 more than the \$0 reported in the 2004 Annual Statement. The above captioned amount for "Stocks: Common stocks" is \$284,567 more than the \$15,975,911 reported by the Company in its 2004 Annual Statement. The change in the "Reinsurance payable on paid loss and loss adjustment expenses" account is due to a balance that the Company owes its wholly owned subsidiary, Omega One Insurance Company (Omega), for loss and loss adjustment expenses Omega incurred in relation to CAT Occurrence 74 which occurred in October 2002. The balance developed in relation to the catastrophe reinsurance agreement between the Company and Omega. The balance was not reflected in the Company's filed financial statements. The increase in the "Stocks: Common stocks" is due to the fact that the Company is the sole shareholder of Omega and reports its investment in Omega based on the underlying statutory equity of Omega's financial statements in accordance with SSAP No. 46, paragraph 7(b). In relation to the balance that was not recorded by either entity, Omega received a benefit to surplus of \$355,709 less a "Provision for reinsurance" liability that was required to be held of \$71,142 in relation to the aged balance.

<b><u>Note 7 – Unearned premiums</u></b>	<b><u>\$13,055,606</u></b>
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The above captioned amount is the same as reported by the Company in its 2004 Annual Statement.

The Company did not utilize either of the prescribed methods described in SSAP No. 53 in calculating its unearned premiums for a segment of acquired business known by the Company as "Vesta business." SSAP No. 53, paragraph 7 requires, "One of the following methods shall be used for computation of the unearned premium reserve: Daily pro rata method...Monthly pro rata



method...” The Company utilized a method that involved an assumption that each of the policies in force at December 31, 2004, had a corresponding unearned premium reserve of approximately two months. The premiums records in relation to the aforesaid segment of business have not been integrated into the Company’s premium administration system. The examiners required the Company to calculate the reserve using either of the prescribed methods for its “Vesta business.” The Company provided a calculation of the unearned premiums utilizing the daily pro rata method. The revised unearned premiums were verified to be accurate by the examiners. The examination indicated that the Company’s unearned premiums were understated by \$44,706. Due to immateriality no changes were made to the financial statements included in this report.

<b><u>Note 8 – Funds held by company under</u></b>	<b><u>\$102,320</u></b>
<b><u>reinsurance treaties</u></b>	
<b><u>Amounts withheld or retained by</u></b>	<b><u>\$752,116</u></b>
<b><u>company for account of others</u></b>	

The above captioned amounts are the same as reported in the Company’s 2004 Annual Statement.

The Company included four amounts totaling \$42,350 incorrectly classified in the line item “Amounts withheld or retained by company for account of others.” The balances were determined to be in relation to reinsurance treaties. These amounts should have been classified in the line item “Funds held by company under reinsurance treaties” in accordance with the NAIC Annual Statement Instructions, which stipulate to include “Reinsurance premiums withheld by the company as specified in the reinsurance contract (for example, funds withheld equal to the unearned premiums and loss reserves) or advances to the company for the payment of losses before the company makes an accounting.”

There was no effect on surplus due to this misclassification. No changes were made in the financial statements for the misclassification.

<b><u>Note 9 – Provision for Reinsurance</u></b>	<b><u>\$341,000</u></b>
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The above captioned amount is the same as reported by the Company in its 2004 Annual Statement.

The Company improperly accounted for its aged reinsurance recoverables at December 31, 2004. The Company non-admitted aged reinsurance recoverables that it expects to eventually recover and did not report the aged reinsurance recoverables in the Annual Statement schedules related to Provision for reinsurance. The Company's accounting for reinsurance recoverables was not in compliance with SSAP No. 62, paragraph 19, and the NAIC Annual Statement Instructions for Schedule F, Parts 3 through 7. Proper reporting of the 2004 aged reinsurance recoverables would have resulted in an immaterial increase to the Company's Surplus. No adjustment was made to the financials contained in this report due to the adjustment being immaterial.

#### **Note 10 – Unassigned funds**

**\$20,850,842**

The above captioned amount is \$738,102 less than the \$21,588,944 reported by the Company in its 2004 Annual Statement. The following is a reconciliation of unassigned funds per this examination:

Unassigned funds per Company		\$21,588,944
Examination increase/(decrease) to assets:		
Stocks: Common stocks	\$ 284,567	
Cash and short-term investments	\$(766,979)	
Other invested assets	\$(352,453)	
Premiums and considerations: Uncollected premiums and agents' balances in course of collection	\$(314,507)	
Examination (increase)/decrease to liabilities:		
Reinsurance payable on paid loss and loss adjustment expenses	\$(355,709)	
Drafts outstanding	\$ 766,979	
Change in Unassigned funds	\$ 0	\$ (738,102)
Total Unassigned funds per examination		\$20,850,842

### **COMMENTS AND RECOMMENDATIONS**

#### **Committees – Page 4**

It is recommended that the Company keep minutes of its Investment Committee meetings as required by ALA. CODE §10-2B-16.01(a)(1975), which states,

A corporation shall keep as permanent records minutes of all meetings of its shareholders and board of directors, a record of all actions taken by the shareholders or board of directors without a meeting, and a record of all actions taken by a committee of the board of directors in place of the board of directors on behalf of the corporation.

### **Management and Service Agreements – Page 6**

**It is recommended** that the Company comply with the terms of its agreement for claims adjustment services with National Security Insurance Company.

### **Fidelity Bond and Other Insurance – Page 11**

**It is recommended** that the Company maintain fidelity bond coverage of an amount that is at least as much as the minimum amount suggested by the NAIC Financial Condition Examiners Handbook.

### **Policy Forms and Underwriting – Page 13**

**It is recommended** that the Company maintain complete records of its policy files and policy application files as required by ALA. CODE §27-27-29(a)(1975), which states, in part, “Every domestic insurer shall have, and maintain...complete records of its assets, transactions and affairs...”

**It is recommended** that the Company file all policy forms with the Commissioner and receive the Commissioner’s approval before using policy forms as required by ALA. CODE §27-14-8(a)(1975), which states,

No basic insurance policy or annuity contract form or application form where written application is required and is to be made a part of the policy, or contract, or printed rider, or endorsement form or form of renewal certificate shall be delivered or issued for delivery in this state unless the form has been filed with, and approved by, the commissioner...

### **Claims Review – Page 15**

**It is recommended** that the Company properly acknowledge claims within 15 days as required by ALA. ADMIN. CODE 482-1-125-.06(1), which states,

Every insurer, upon receiving notification of a first party claim from a first party claimant shall, within fifteen (15) days, acknowledge the receipt of such notice unless payment is made within that period of time. If an acknowledgement is made by means other than writing, an appropriate notation of the acknowledgement shall be made in the claim file of the insurer and dated. Notification given to a producer of an insurer shall be notification to the insurer. Acknowledgement by a producer of an insurer as required above shall satisfy the requirements of this paragraph.

**It is recommended** that the Company maintain complete records of its claims files in accordance with ALA. ADMIN. CODE 482-1-125.04, which states,

#### File and record documentation

Each insurer's claim files for policies are subject to examination by the Commissioner of Insurance or by the Commissioner's duly appointed designees. To aid in such examination:

(a) The insurer shall maintain claim files that are accessible and retrievable for examination. An insurer shall be able to provide the claim number, line of coverage, date of loss, and date and amount of payment. They shall also be able to provide the same information (except date and amount of payment) for all claims closed without payment. This data must be available for all open and closed files for the current year and the five (5) preceding years, in order to permit reconstruction of the insurer's activities relative to each claim.

(b) Each relevant document within the claim file shall reflect as to date received, date processed or date mailed.

#### **Policyholder Complaints – Page 16**

**It is recommended** that the Company respond to complaints in which they are notified of by the Alabama Department of Insurance within ten business days of being notified in writing of the complaint in accordance with Alabama Insurance Department Regulation No. 118 §(6)(s), which states, "The insurer shall provide, within ten (10) working days, any record or response requested in writing by any duly appointed deputy, assistant, employee or examiner of the commissioner..."

### **Reinsurance Assumed – Page 18**

**It is recommended** that the Company revise its reinsurance agreement with Omega One Insurance Company to include a provision for premiums and losses and payment of losses reporting as specified by SSAP No. 62, paragraph 8(d), and an errors and omissions clause.

**It is recommended** the Company reimburse Omega One Insurance Company for the covered losses under its reinsurance agreement with the Company for losses incurred for CAT Occurrence 74. It is further recommended that the Company comply with the terms of its reinsurance agreement with its wholly owned subsidiary.

### **Reinsurance Ceded – Page 19**

**It is recommended** that the Company ensure all reinsurance contracts are signed within nine months of the policy commencement date or account for the reinsurance arrangements on a retroactive basis in accordance with SSAP No. 62, paragraph 23, which states, "If an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commence of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement."

### **Accounts and Records – Page 23**

**It is recommended** that the Company employ a different CPA than the one that has been responsible for the independent auditor's report for each year from 1992 to 2004 to remedy the Company's failure to comply with Alabama Department of Insurance Regulation 482-1-100-.07(4)(a), which states, "No partner or other person responsible for rendering a report may act in that capacity for more than seven (7) consecutive years..."

**It is recommended** that the Company require its CPA to evaluate the Company's relationship with the consulting and opining actuary to determine whether the actuary's work is to be relied upon for the independent audit as required by AICPA Professional Standards Sections 336.10 and 336.11, which state,

The auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has the ability---through employment, ownership, contractual right, family relationship, or otherwise---to directly or indirectly control or significantly influence the specialist. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. However, the work of a specialist who has a relationship with the client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

**It is recommended** that the Company cease the practice of borrowing funds from its wholly owned subsidiary, Omega One Insurance Company, because such loans require the Company's subsidiary to violate ALA. CODE §27-41-36(1975), which states,

An insurer shall not invest in nor lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer, except as to policy loans authorized under Section 27-41-25 and except as provided in Sections 27-1-2, 27-27-26 and 27-37-2 of the Alabama Insurance Code.

It was noted that the most recent Report of Examination included a recommendation for the Company to cease the practice of borrowing funds from its subsidiary. Further discussion of the Company's loan from its subsidiary is included in this report under the caption "COMPLIANCE WITH PRIOR RECOMMENDATIONS."

**It is recommended** that the Company maintain complete records of its policy files as required by ALA. CODE §27-27-29(a)(1975), which states, in part, "Every domestic insurer shall have, and maintain...complete records of its assets, transactions and affairs."

**It is recommended** that the Company report prepaid expenses as a nonadmitted asset in accordance with SSAP No. 29, paragraph 2, which states,

in part, "Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus)."

**It is recommended** that the Company include its outstanding checks that are issued to payees with last known addresses in Alabama that have been outstanding over five years in its Alabama unclaimed property filing. Such checks were determined to be unclaimed property in accordance with ALA. CODE §35-12-23(b), which states, " 'Unclaimed funds', as used in this section, means all monies held and owing by any insurance corporation unclaimed and unpaid for more than five years after the moneys became due and payable as established from the records of the corporation." It is further recommended that the Company properly escheat the unclaimed property of other states to the respective states as well.

### **Bonds – Page 32**

**It is recommended** that the Company not admit any assets that are not freely subject to withdrawal or liquidation by the insurer at any time for the payment of claims or other obligations, consistent with ALA. CODE §27-37-4(b)(1975), which states, "The commissioner shall disallow as an asset any deposit, funds or other assets of the insurer found by him after a hearing thereon...(2) Not freely subject to withdrawal or liquidation by the insurer at any time for the payment or discharge of claims or other obligations arising under its policies..."

**It is recommended** that the Company follow the instructions of the Purposes and Procedures Manual of the NAIC SVO in assigning the NAIC designations to filing exempt securities.

### **Cash and short-term investments and Drafts outstanding – Page 32**

**It is recommended** that the Company properly classify its outstanding checks as a reduction of cash in accordance with SSAP No. 2, paragraph 7, which stipulates, "Outstanding checks are accounted for as a reduction of cash."

**It is recommended** that the Company maintain complete records of its outstanding obligations in accordance with ALA. CODE §27-27-29(a)(1975), which states, in part, "Every domestic insurer shall have, and maintain...complete records of its assets, transactions and affairs..."

**It is recommended** that the Company reflect all outstanding checks as a reduction in the Cash and short-term deposits balance that it reports in its financial statements.

**It is recommended** that the Company reflect all reversed deposit items as a reduction in the Cash and short-term investments balance that it reports in its financial statements.

**It is recommended** that the Company accurately report its special deposits in its Annual Statement Schedule E – Part 3.

**Premiums and considerations: Uncollected premiums and agents' balances in course of collection and Receivables from parent, subsidiaries and affiliates – Page 35**

**It is recommended** that the Company not admit its agents' receivables on a policy by policy basis which are over 90 days past due in accordance with SSAP No. 6, paragraph 9(c), which states, in part, "The uncollected agents' receivable on a policy by policy basis which is over ninety days due shall be nonadmitted regardless of any unearned premium."

**It is recommended** that the Company report its assumed reinsurance premiums balances in the line item "Premiums and considerations: Uncollected premiums and agents' balances in course of collection" in accordance with SSAP No. 62, paragraph 35, which states, "Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents' balances or uncollected premiums."

**Premiums and considerations: Deferred premiums, agents' balances and installments booked but deferred and not yet due – Page 36**

**It is recommended** that the Company report all Annual Statement balances as of December 31 in accordance with ALA. CODE §27-3-26(a)(1975), which requires that the Company "...file with the commissioner a full and true statement of its financial condition, transactions and affairs as of the December 31, preceding."



### **Unearned premiums – Page 37**

It is recommended that the Company properly calculate its unearned premiums utilizing one of the prescribed methods of SSAP No. 53, paragraph 7, which requires, “One of the following methods shall be used for computation of the unearned premium reserve: Daily pro rata method...Monthly pro rata method...”

### **Funds held by company under reinsurance treaties and Amounts withheld or retained by company for account of others – Page 38**

It is recommended that the Company properly classify its reinsurance related balances in the line item “Funds held by company under reinsurance treaties” in accordance with the NAIC Annual Statement Instructions, which stipulate to include “Reinsurance premiums withheld by the company as specified in the reinsurance contract (for example, funds withheld equal to the unearned premiums and loss reserves) or advances to the company for the payment of losses before the company makes an accounting.”

### **Provision for Reinsurance – Page 38**

It is recommended that the Company account for aged reinsurance recoverables in accordance with SSAP No. 62, paragraph 19, and the NAIC Annual Statement Instructions for Schedule F, Parts 3 through 7, and to complete the Annual Statement schedules related to the Provision for reinsurance.

### **Compliance With Previous Recommendations – Page 47**

It is recommended that the Company comply with Report of Examination recommendations.

### **Subsequent Events – Page 48**

It is recommended that the Company properly report commercial loans payable in the line item “Borrowed money and interest thereon” in future financial statements.

## **CONTINGENT LIABILITIES AND PENDING LITIGATION**

The review of contingent liabilities and pending litigation included an inspection of representations made by management and a general review of the Company's records and files conducted during the examination, including a review of claims. These reviews did not disclose any items that would have a material effect on the Company's financial condition in the event of an adverse outcome.

## **COMPLIANCE WITH PREVIOUS RECOMMENDATIONS**

A review was performed to determine if the Company had complied with the recommendations made in the last examination report. The review indicated that the Company had complied with the recommendations contained in the immediately preceding Report of Examination with the exception of the items listed below.

The previous Report of Recommendation recommended that the Company cease the practice of borrowing funds from its wholly owned subsidiary, Omega One Insurance Company. This examination noted that the Company did not comply with the recommendation. Further discussion of the Company's loan from its subsidiary is contained in this report under the caption "ACCOUNTS AND RECORDS – Loan from Subsidiary."

The previous Report of Examination recommended that the Company classify and report statutory financial statement liabilities in accordance with the NAIC Annual Statement Instructions. It was noted that the recommendation referenced two Annual Statement line items: "Funds held by company under reinsurance treaties" and "Amounts withheld or retained by company for the account of others." This examination noted that the Company did not comply with the recommendation. The Company had balances that were determined to be misclassified involving the two aforesaid accounts. Further discussion of the misclassification is included in this report under the caption "NOTES TO FINANCIAL STATEMENTS – Note 6."

## **SUBSEQUENT EVENTS**

The review of events subsequent to December 31, 2004, revealed that the Company received an additional paid in capital contribution from its parent, National Security Group, Inc., in the amount of \$6,000,000 in order to increase capital capacity for future premium growth.

The examination noted that the Company reported a \$1 million commercial loan payable as Capital Notes in its September 30, 2005, Quarterly Statement. The Company subsequently acknowledged it should have reported the loan as "Borrowed money and interest thereon" in its Quarterly Statement. The examination also noted that the Company did not properly report the loan in Note 11 (Debt) of the Quarterly Statement's Notes to Financial Statements.

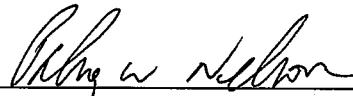
## CONCLUSION

Acknowledgement is hereby made of the courtesy and cooperation extended by all persons representing National Security Fire & Casualty Company during this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

In addition to the undersigned, Toni Bean, Angie Block, Douglas Brown, Laura Chapman, Bobby McKinnon, Felicia McKinzy, Alfonzo Nunn and Thomas Salo, Examiners; and Glenn Taylor, FCAS, MAAA, and Randall Ross, FCAS, MAAA, of Taylor-Walker & Associates, Consulting Actuary; all representing the Alabama Department of Insurance, participated in this examination of National Security Fire & Casualty Company.

Respectfully submitted,



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Palmer W. Nelson, CFE

Examiner-in-charge

Alabama Department of Insurance  
Southeastern Zone, NAIC